A. Charging Order Protection

1. Protecting Assets within Entities

Often, asset protection practitioners will talk about inside out and outside in asset protection. This is a critical distinction.

Example: Dr. Brown is a neurosurgeon. He owns 2 apartment buildings having a combined equity of $10 million. Apartment building "A" is owned by Dr. Brown through a corporation, while apartment building "B" is owned through a limited liability company, taxed as a partnership for income tax purposes.

Assume that two tenants, one residing in a building A and the other in building B, slip, fall and sue, and Dr. Brown's general liability insurance policy is insufficient to cover the claims. Because the buildings are owned by a corporation and a limited liability company, the tenants have to sue these two entities. If the tenants are successful, they will be able to recover against the entities, but, ordinarily, will not be able to pierce the entities and go after the individual owners, namely, Dr. Brown.

Assume now that two of Dr. Brown's patients sue Dr. Brown and the judgment exceeds the limits of Dr. Brown's malpractice policy. The patients will attempt to enforce the judgment against all of Dr. Brown's assets, including his interests in the corporation and the LLC.

The patient-creditor will be able to obtain a writ of execution or a turnover order against Dr. Brown's interest in the corporation, effectively getting apartment building A.

This is an extremely important point to remember. Corporations are often thought of as limited liability entities. The referenced limited liability is that of the shareholder when the corporation is sued. The same limited liability does not apply to the corporation when the shareholder is sued.

2. Charging Order Limitation

Returning to Dr. Brown, what happens to apartment building B, the one owned by the LLC? Fortunately for Dr. Brown, the result is different.

Membership interests in LLCs and partnership interests are afforded a significant level of protection through the charging order mechanism. The charging order limits the creditor of a debtor-partner or a debtor-member to the debtor's share of distributions, without conferring on the creditor any voting or management rights. While that may not seem like much at first glance, in practice, the charging order limitation is a very powerful asset protection tool.

a. The Importance of History

Before the advent of the charging order,[1] a creditor pursuing a partner in a partnership was able to obtain from the court a writ of execution directly against the partnership's assets, which led to the seizure of such assets by the sheriff. This result was possible because the partnership itself was not treated as a juridical person, but simply as an aggregate of its partners.

The seizure of partnership assets was usually carried out by the sheriff, who would go down to the partnership's place of business and shut it down. That caused the non-debtor partners to suffer financial losses, sometimes on par with the debtor partner, and the process was considered to be entirely "clumsy."[2]

To protect the non-debtor partners from the creditor of the debtor-partner it was necessary to keep the creditor from seizing partnership assets (which was also in line with the developing perception of partnerships as legal entities and not simple aggregates of partners) and to keep the creditor out of partnership affairs. These objectives could only be accomplished by limiting the collection remedies that creditors previously enjoyed. Because any limitation on a creditor's remedies is a boon to the debtor, over the years charging orders have come to be perceived as asset protection devices.

The rationale behind the charging order applied initially only to general partnerships, where every partner was involved in carrying on the business of the partnership; it did not apply to corporations because of their centralized management structure.[3] However, over the years the charging order protection was extended to limited partners and LLC members.

b. The Uniform Acts

Both partnership statutes and limited liability company statutes (in most domestic and foreign jurisdictions that have these entity types) provide for charging orders. In almost all the states (including California) partnership and LLC statutes are based on the uniform acts, such as the Revised Uniform Partnership Act of 1994 ("RUPA"), the Uniform Limited Partnership Act of 2001 ("ULPA") or the Uniform Limited Liability Company Act of 1996 ("ULLCA"), or the earlier versions of these acts.

The very first references to the charging order (in the United States) appeared in Section 28 of the Uniform Partnership Act of 1914 and Section 22 of the Uniform Limited

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[1] The first charging order statute appeared in Section 23 of the English Partnership Act of 1890, and was later picked up by the Uniform Partnership Act (Section 28) of 1914, and the Uniform Limited Partnership Act (Section 22) of 1916.

[2] Brown, Janson & Co. v. A. Hutchinson & Co., 1895 Q.B. 737 (Eng. C.A.).

[3] Because charging orders do not apply to corporations, a creditor of a shareholder can attach the shares of corporate stock owned by the debtor-shareholder and obtain the entire bundle of rights inherent in those shares, including liquidation and voting rights.

Partnership Act of 1916 and allowed creditors to petition the court for a charging order against the debtor's partnership interest. Both statutes, directly or indirectly, addressed the fact that the charging order was not the exclusive remedy of the creditor. Appointment of a receiver and foreclosure of the partnership interest were anticipated.

The subsequent amendment to the Uniform Limited Partnership Act (in 1976), clarified the charging order remedy by stating that the judgment creditor had the rights of an assignee of the partnership interest.

The RUPA, at Section 504, and the ULLCA, at Section 504, introduced the following new concepts: (i) the charging order constitutes a lien on the judgment debtor's transferable interest; (ii) the purchaser at a foreclosure sale has the rights of a transferee; and (iii) the charging order is the exclusive means by which the creditor could pursue the partnership interest.

Both acts also provide that the charging order does not charge the entire partnership or membership interest of the debtor, but only the "transferable" (RUPA) or "distributional" (ULLCA) interest. However, the language providing that the creditor has the rights of an assignee was dropped.

The ULPA (the last act, chronologically), in addition to the new language in the RUPA and the ULLCA provides, further, at Section 703, that (i) the judgment creditor has only the rights of a transferee,[4] and (ii) the court may order a foreclosure only on the transferable interest.[5]

All three most recent acts also provide that the charged interest may be redeemed prior to foreclosure.[6]

There are four important points to take away from the wording of these uniform acts: (1) the charging order is a lien on the judgment debtor's transferable/distributional interest, it is not a levy, (2) the creditor can never exercise any management or voting rights because the creditor has only the rights of an assignee/transferee, (3) the foreclosure of the charged interest does not harm the debtor because the buyer at the foreclosure sale receives no greater right than was possessed by the original creditor, and (4) the creditor, expressly, has no other remedies, but the charging order (and foreclosure on the charging order).

Because the charging order creates a lien and not a levy, and because the creditor is not even a transferee under ULPA, but only has the rights of a transferee, the creditor does not become the owner of the charged interest unless there is foreclosure. This has important tax ramifications (which are discussed below).

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[4] ULPA, Section 703(a).
[5] ULPA, Section 703(b).
[6] RUPA Section 504(c), ULLCA Section 504(c), ULPA Section 703(c).

By calling the creditor an assignee/transferee, or by stating that the creditor has the rights of an assignee/transferee, the uniform acts deprive the creditor of any voting, management or access to information rights.[7] Let us use ULPA to see how that happens.

ULPA defines a "transferable interest" as a right to receive distributions.[8] A "transferee" is defined as a person who receives a transferable interest.[9] ULPA defines two bundles of rights that a partner may have in a partnership: economic rights and other rights.[10] While economic rights are freely transferable, other rights (which include management and voting rights) are not transferable at all, unless provided otherwise in the partnership agreement.[11]

ULPA further clarifies that a transferee only has the right to receive distributions, if and when made.[12] This is further elaborated upon by comments to the charging order section of ULPA:

> This section balances the needs of a judgment creditor of a partner or transferee with the needs of the limited partnership and non-debtor partners and transferees. The section achieves that balance by allowing the judgment creditor to collect on the judgment through the transferable interest of the judgment debtor while prohibiting interference in the management and activities of the limited partnership.
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> Under this section, the judgment creditor of a partner or transferee is entitled to a charging order against the relevant transferable interest. While in effect, that order entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. The creditor has no say in the timing or amount of those distributions. The charging order does not entitle the creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership.
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> Foreclosure of a charging order effects a permanent transfer of the charged transferable interest to the purchaser. The foreclosure does not, however, create any rights to participate in the management and conduct of the limited partnership's activities. The purchaser obtains nothing more than the status of a transferee.[13]

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[7] This is a reflection of two principles: (i) the creditor should be kept out of the entity so that the non-debtor owners are not inconvenienced, and (ii) the so-called "pick your partner" philosophy that allows partners and members to approve any new incoming partner/member. See, for example, RUPA, Section 401(i).
[8] ULPA Section 102(22).
[9] ULPA Section 102(23).
[10] ULPA Section 701.
[11] *Id*.
[12] *Id*.
[13] ULPA Section 703, Comments.

ULLCA has similar provisions that restrict the creditor to a "distributional interest" (identical, except in name, to ULPA "transferable interest") that does not confer on the creditor any voting or management rights.[14]

The creditor's inability to vote the charged interest or participate in the management of the entity is at the heart of the asset protection efficacy of the charging order. If the partnership or the LLC halts all distributions, the creditor has no ability to force the distributions.

Much fear has been expressed by some practitioners about the creditor's ability to foreclose.[15] This fear appears to be entirely unfounded – the uniform acts clearly provide that only the charged interest may be foreclosed upon, and further provide that the purchaser at the foreclosure sale has only the rights of a transferee. To grant the purchaser of the foreclosed interest an interest greater than the right to receive distributions would mean granting to the purchaser voting and management rights associated with the debtor's interest in the entity. That would be contrary to the very reason why charging order statutes exist in the first place.

A creditor holding a charging order usually does not know whether any distributions will be forthcoming from the entity. This uncertainty is of little value to most creditors. But it may be possible to find a third party, possibly a collection firm, that may buy the charged interest at a steep discount and then wait to get paid (which may be folly due to possible adverse tax consequences). Consequently, the ability to foreclose affords the creditor some limited value.

The creditor's ability to foreclose is not, in any way, detrimental to the debtor. So long as no one can take away the debtor's management and voting rights, the debtor is not made worse off.

The exclusivity of the charging order (including the ability to foreclose on the charging order), which may be found in each recent uniform act, relates back to the origin of the charging order. The drafters of the uniform acts did not want to allow the creditor any possibility of gaining voting or management rights, and the exclusivity language should be read in that light.

A common point of confusion needs to be addressed with respect to exclusivity. Many cases dealing with charging orders focus on whether the charging order is the exclusive creditor remedy, or whether foreclosure is authorized (see discussion below). The uniform acts, until RUPA in 1994, never made the charging order the exclusive creditor remedy, although it was always understood that the creditor can never gain management

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[14] ULLCA Sections 101(6), 501-504.

[15] See, for example, Elizabeth M. Schurig and Amy P. Jetel, *A Charging Order is the Exclusive Remedy Against a Partnership Interest: Fact or Fiction?,* Prob. & Prop. (Nov./Dec. 2003). See also the critique of the above referenced article in the same publication: Daniel S. Kleinberger, Carter G. Bishop and Thomas Earl Geu, *Charging Orders and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster*, Prob. & Prop. (Jul./Aug. 2004).

rights. Beginning with RUPA, all uniforms acts have introduced the element of exclusivity, but it is not the charging order that is made the exclusive remedy. Instead, the acts make the respective sections of the acts dealing with charging orders the exclusive remedy, and these sections specifically allow foreclosure.

Some practitioners and commentators[16] have suggested that the exclusivity language may mean that fraudulent transfer laws would not apply to transfers of assets to partnerships or limited liability companies.[17] While a strict reading of the exclusivity language may, at first glance, suggest such an outcome, it would be incorrect. The charging order limitation protects the debtor's interest in the legal entity. If a creditor successfully establishes that a transfer of assets to a legal entity is a fraudulent transfer (which would be a separate legal action from the application for a charging order), the creditor no longer needs to pursue the debtor's interest in the entity. With a fraudulent transfer judgment, the creditor gains the ability to pursue the entity itself, in its capacity as the transferee of the assets. Accordingly, if the creditor has the ability to pursue the partnership or the LLC, the protection of the debtor's interest in the entity through the charging order becomes a moot point. Several courts have now opined on this subject as well, uniformly holdings that the exclusivity language of the charging order statutes is not a bar to a fraudulent transfer challenge.[18]

c. California Statutes on Charging Orders

CCP Section 708.310 provides:

> If a money judgment is rendered against a partner but not against the partnership, the judgment debtor's interest in the partnership may be applied toward the satisfaction of the judgment by an order charging the judgment debtor's interest pursuant to Section 15029 or 15673 of the Corporations Code.

In turn, Section 15673 of the Corporations Code provides:

> On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the limited partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the limited partnership interest.

Section 15672 then provides:

> An assignment of a limited partnership interest does not dissolve a limited partnership or, other than as set forth in this chapter, entitle the assignee to

[16] See the discussion of the Alaska charging order statute in the Kleinberger, Bishop and Geu article.
[17] Find cite, was mentioned in one of the articles
[18] See, for example, Taylor v. S & M Lamp Co., 190 Cal. App. 2d 700, 708 (1961); Chrysler Credit Corp. v. Peterson, 342 N.W. 2d 170, 172 (Minn. 1984); Firmani v. Firmani, 332 N.J. Super. 118, 752 A.2d 854 (N.J. 2000).

> become or to exercise any rights of a partner. An assignment entitles the assignee to receive, to the extent assigned, the distributions and the allocations of income, gain, loss, deduction, credit, or similar item, to which the assignor would be entitled.

Section 17302(a) of the Corporations Code provides similarly with respect to limited liability companies:

> On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the assignable membership interest of the judgment debtor to satisfy the judgment.

Section 17301 then provides:

> (a)(1) A membership interest or an economic interest is assignable in whole or in part, provided, however, that no membership interest may be assigned without the consent of a majority in interest of the members not transferring their interests.
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> (a)(2) An assignment of an economic interest does not of itself dissolve the limited liability company or, other than as set forth in the articles of organization or operating agreement, entitle the assignee to vote or participate in the management and affairs of the limited liability company or to become or exercise any rights of a member.
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> (a)(3) An assignment of an economic interest merely entitles the assignee to receive, to the extent assigned, the distributions and the allocations of income, gains, losses, deductions, credit, or similar items to which the assignor would be entitled.

The "membership interest" is defined in Section 17001(z) as:

> Membership interest means a member's rights in the limited liability company, collectively, including the member's economic interest, any right to vote or participate in management, and any right to information concerning the business and affairs of the limited liability company provided by this title.

The "economic interest" is defined in Section 17001(n) as:

> Economic interest means a person's right to share in the income, gains, losses, deductions, credit, or similar items of, and to receive distributions from, the limited liability company, but does not include any other rights of a member, including, without limitation, the right to vote or to participate in management, or, except as provided in Section 17106, any right to information concerning the business and affairs of the limited liability company.

Similar rules apply to general partnerships.[19]

These statutes bring up an interesting question that should be considered by anyone seeking asset protection. If the charging order confers on the creditor assignable/transferable interests, or the rights of an assignee/transferee, can those rights be further restricted?

All uniform acts and state statutes define these terms, and in some way limit assignable/transferable interests to various economic rights, *i.e.*, the right to receive distributions of cash and property. However, all statutes also allow partners and members to enter into agreements – partnership agreements, limited partnership agreements and operating agreements, and to define various rights and interests in those agreements. What would happen if an operating agreement provided that (i) no interests in the LLC may be assigned under any circumstances (not even an economic interest), (ii) no interests may be assigned without the consent of the other members/partners, or the consent of the manager or the general partner, or (iii) interests may not be assigned to a creditor?

ULLCA specifically provides that members may enter into an operating agreement which would define their respective rights and relationships, and enumerates which statutory provisions the members may not waive through the operating agreement.[20] The comment to Section 103 confirms that in the operating agreement the members may override any provision of ULLCA, other than those specifically listed in Section 103.

> This section makes clear that the only matters an operating agreement may not control are specified in subsection (b). Accordingly, an operating agreement may modify or eliminate any rule specified in any section of this Act except matters specified in subsection (b). To the extent not otherwise mentioned in subsection (b), every section of this Act is simply a default rule, regardless of whether the language of the section appears to be otherwise mandatory.[21]

ULLCA provides, further, that as far as the managers, members and transferees are concerned, the operating agreement is more powerful than the articles of organization.[22]

The same line of reasoning may be found in the other uniform acts and the related state statutes.[23]

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[19] Corp. Code Section 16504(a).
[20] ULLCA Section 103.
[21] ULLCA Section 103, Comment. See also, ULLCA Section 110, Reporters' Notes ("A limited liability company is as much a creature of contract as of statute, and the operating agreement is the 'cornerstone' of the typical LLC."
[22] ULLCA Section 203(c).
[23] See, for example, ULPA Section 110; Corp. Code Section 17301(a) (this section discusses the assignability of membership interests, unless provided otherwise in the operating agreement); Colorado Revised Statutes Section 7-80-108.

To date, only a couple of courts have considered this issue as it relates to charging orders. In California, an appellate court gave due consideration to the terms of the partnership agreement in determining whether a creditor could foreclosure on a partnership interest.[24] In a Nevada Supreme Court opinion, the court stated that "the partnership agreements could not divest the district court of its powers provided by statute to charge and sell an interest of a partner in a partnership."[25] However, this statement by the Nevada court is a logical fallacy, as it presumes that the statute gives the court the power to sell the partnership interest. The statute can be interpreted, as described above, to grant the court the ability to sell the partnership interest only when it is allowed by the partnership agreement.

If asset protection is the primarily or sole reason for setting up the limited partnership or the LLC, the partner/member may have nothing to lose by adding, in some form, the non-assignability language. The author particularly favors granting a third-party manager approval rights over assignability and transferability of all interests, including economic rights. The downside of this practice would cause one to default to the standard charging order rules discussed above. The upside would deprive the creditor even from the right to receive distributions. This strategy will not work in Delaware, because the creditor is expressly granted the right to receive distributions.

d. Charging Order Cases

There are not a great many cases on charging orders, primarily for two reasons. First, many creditors fail to find the charging order to be a useful remedy, and seek to settle with the debtor rather than hoping to get a distribution out of the entity. Second, even when creditors pursue the charging order remedy, the charging order is granted by a trial court and is rarely appealed, so there are few published opinions. Many of the reported cases deal with the creditor's ability to foreclose; most cases authorize the creditor to foreclose but restrict the buyer of the interest to the economic component of the interest. There are also some interesting outliers, readily demonstrating the degree of judicial imagination involved in statutory interpretation.

The California Supreme Court has affirmed that the charging order has replaced levies of execution as the remedy for reaching partnership interests.[26] The two most interesting charging order cases out of California are Crocker Nat. Bank v. Perroton,[27] and Hellman v. Anderson.[28]

In Crocker, the court concluded that a partnership interest may be foreclosed upon if the sale of the interest does not violate the partnership agreement and the other partners consent to the sale.[29] In Hellman, the court confirmed that foreclosure of the charged

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[24] Crocker Nat. Bank v. Perroton, 208 Cal. App. 3d 1, 255 Cal. Rptr. 794 (1989).
[25] Tupper v. Kroc, 88 Nev. 146, 154 (1972).
[26] Baum v. Baum, 51 Cal. 2d 610, 612, 335 P. 2d 481, 483 (1959).
[27] 208 Cal. App. 3d 1, 255 Cal. Rptr. 794 (1989).
[28] 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991).
[29] Crocker at 9.

interest is authorized by the charging order statute, but disagreed with Crocker that consent of non-debtor partners is required. The court concluded that consent from other partners is not required because pursuant to the foreclosure sale the buyer receives only the economic interest in the partnership, but not voting or management rights. Consequently, the buyer will never have ability to interfere with the business of the partnership and inconvenience the non-debtor partners.[30] Going even further, the Hellman court remanded the case back to trial court for a determination whether the foreclosure of the economic interest (limited as that interest may be) would unduly interfere with the partnership business.[31]

In the only reported Florida opinion,[32] the court concluded that the simplicity of the language of the charging order statute - "the judgment creditor has only the rights of an assignee" - "necessarily" precluded foreclosure.[33] Florida statutes were subsequently amended to specifically preclude foreclosure (see above).

A Minnesota court held that the "exclusivity" of the charging order must be read in conjunction with the Uniform Fraudulent Conveyances Act.[34] In this case a limited partnership interest subject to a charging order was transferred in a fraudulent conveyance to the debtor's wife and attorney. The creditor was allowed to pursue the limited partnership interest transferred through the fraudulent conveyance and retain its charging order.

In Deutsch v. Wolff,[35] a Missouri court analyzed, in a charging order context, the receiver's right to manage the partnership. The court drew a distinction between a creditor who becomes an assignee of the debtor-partner (no management rights), and a receiver appointed by the court. A receiver may be granted management rights "when manager of a partnership has willfully engaged in a series of illegal activities…"[36] It seems that in this case the court found the ability to appoint the receiver through the Missouri charging order statute, but vested the receiver with management rights using equity arguments unrelated to the charging order (*i.e.*, a receiver could have been appointed simply because the general partner was defrauding the limited partners). A similar conclusion, under similar circumstances, was reached by courts in Nevada, [37] Kansas[38] and Minnesota.[39]

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[30] Hellman at 852.
[31] *Id*. at 853.
[32] A prior decision in Myrick v. Second National Bank of Clearwater, 335 So. 2d 343 (1976) was made under Florida's version of UPA and has been superseded by the subsequent adoption of RUPA.
[33] Givens v. National Loan Investors L.P., 724 So. 2d 610 (1998).
[34] Chrysler Credit Corp. at 172-173.
[35] 7 S.W. 3d 460 (1999).
[36] *Id*. at 464.
[37] Tupper at 155.
[38] Arkansas City v. Anderson, 242 Kan. 875, 752 P. 2d 673 (Kan. 1988).
[39] Windom Nat'l Bank v. Klein, 254 N.W. 602, 605 (Minn. 1934).

In Baker v. Dorfman,[40] a New York district court assigned 75% of the single-member's interest in an LLC (the assignment was limited to the profits of the LLC) to the judgment creditor (pursuant to the New York LLC charging order statutes) and appointed a receiver. The receiver was empowered by a magistrate not only to collect the profits, but also to participate in the management of the LLC and to work to increase its profitability. The LLC itself was also a debtor of the judgment creditor in its capacity as a successor in liability of the member-debtor.

The magistrate's ability to do anything but collect profits was later affirmed (with minor modifications) by the Second Circuit.[41] By granting the receiver the ability to manage the LLC, the court certainly went far beyond New York's charging order statute (discussed above). Similar to Deutsch, Tupper, Arkansas City and Windom, there were allegations of fraud against the debtor, and appointment of the receiver may have been possible even absent a charging order. These cases seem to reaffirm that a debtor subject to a charging order cannot lose its management rights because of the charging order.

In a different New York decision, the court concluded that the charging order was not the sole remedy authorized by the charging order statute, and that levy of the charged interest was proper.[42] The court did make it apparent that the levy did not confer on the creditor a greater interest than the one obtained through the charging order.

e. Single-Member LLCs

Single-member LLCs deserve special attention in the charging order analysis. It may be argued that given the historical framework of charging orders, their protection should not extend to single member LLCs (there are no other "partners" to protect from the creditor).

However, neither the uniform acts nor any of the state charging order statutes make any distinction between single-member and multi-member LLCs. Some courts have held that the charging order protection would apply in a case where all of the partners of a limited partnership were the debtors of a single creditor.[43] The creditor had argued to no avail that because there were no "innocent" (non-debtor) partners to protect, the charging order protection should not apply.

One bankruptcy court held that the charging order protection does not apply to single-member LLCs.[44] In Albright, the debtor was the sole member and manager of an LLC. The bankruptcy trustee asserted that it acquired the right to control the LLC and sell its

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[40] 2000 U.S. Dist. LEXIS 10142 (S.D.N.Y. 2000), affirmed in part and reversed in part in 232 F.3d 121 (2000).
[41] 232 F. 3d 121, 122 (2000).
[42] Princeton Bank and Trust Company v. Berley, 57 A.D. 2d 348, 394 N.Y.S. 2d 714 (1977). See, also, *Beckley v. Speaks*, 240 N.Y.S. 2d 553 (1963).
[43] Evans v. Galardi , 16 Cal. 3d 300 (Cal. 1976).
[44] In re Albright, 291 B. R. 538 (Bankr. D. Colo. 2003).

assets, while the debtor sought to deny those rights to the trustee, based on the above discussion of charging orders.

The bankruptcy court concluded that based on the Colorado LLC statutes, a membership interest in an LLC can be assigned, including management rights.[45] The relevant statute provides that if all the other members do not approve of the assignment, then the assignee does not acquire management rights.[46] If all the other members do approve, then the assignee may become a substituted member (and acquire all rights of a member).[47]

Because in a single-member LLC there are no other members that can "not approve," an assignee will always become a substituted member. The statute was obviously never revised following the introduction of single-member LLCs. The bankruptcy court concluded that if the LLC in Albright was a multi-member LLC, a different result would be reached and the bankruptcy trustee would be entitled only to the distributions of profits, but not management and control over the LLC.[48]

The court's application of the Colorado assignability statutes is faulty. These statutes are implicated only when a member dies or assigns its interest, not in the context of bankruptcy.[49]

The Albright case is often interpreted as a case on single-member LLC charging orders. However, the bankruptcy court devoted most of its analysis to the assignability of interests statutes, and only in passing noted that the debtor made a charging order argument. The court dismissed the debtor's charging order argument out of hand, noting that charging orders were intended to protect non-debtor "partners," and in single-member LLCs there is no one to protect.[50]

The very limited analysis of charging orders engaged in by the Albright court is troubling. The court analyzes and follows Colorado statutes when dealing with the assignability of interests and determining how the charging order would work in a multi-member context. For an unexplained reason, the court completely abandons the Colorado statutes in determining the applicability of the charging order. The Colorado charging order statute does not exempt single-member LLCs from the protection of the charging order.[51] The court completely ignores that and focuses on the historical framework of charging orders.

When there is a clear statute on point, engaging in the analysis of legislative intent and historical origins of statutes is inappropriate.[52] The Colorado charging order statute

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[45] Colo. Rev. Stat. Section 7-80-702.
[46] Colo. Rev. Stat. Section 7-80-702(1).
[47] Colo. Rev. Stat. Section 7-80-702(2).
[48] Albright at 541.
[49] Colo. Rev. Stat. Sections 7-80-702 and 7-80-704.
[50] *Id*. at 542-543.
[51] Colorado Revised Statutes Section 7-80-703.
[52] See, e.g., Robert E. v. Justice Court, 99 Nev. 443, 445, 664 P.2d 957, 959 (1983) ("When presented with a question of statutory interpretation, the intent of the legislature is the controlling factor and, if the statute

clearly limits the creditor to an economic interest in the LLC.[53] When the Colorado legislature introduced the single-member LLC statute it is presumed to have known of the charging order statute.[54] It chose not to make any changes to the latter. The Albright decision conveniently ignores these legal principles.[55]

To date, with the exception of the Albright case, there are no cases analyzing the efficacy of charging orders in the single-member LLC context. Attorneys should caution their clients that if they are seeking to maximize their charging order protection, they should be forming multi-member LLCs or adding new members to existing LLCs. These new members would need to have some membership interest in the LLC, but is difficult to gage how large of an interest would be sufficient, and whether an economic interest would suffice, or are voting rights required as well. In Albright, the court concluded that if the analysis was carried out under the Colorado charging order statute, and there was another member, with a passive interest, of an "infinitesimal" nature, the bankruptcy trustee would not acquire any management or control rights.[56]

In a community property state like California, if an LLC has spouses as the only two members, and the interests in the LLC are community property of the spouses, such an LLC would probably not enjoy the protection of a multi-member LLC. If either spouse is a debtor, then under the community property laws the creditor will be able to charge the LLC interests of both spouses. This would mean that there would be no non-debtor members to protect with the charging order.

f. Reverse Piercing

Because of the charging order limitation, partnerships and LLCs afford a liability shield to its owners, by protecting (to some extent) the assets within these entities from personal liabilities of the owners. Similar to the traditional liability shield commonly associated with limited liability entities, the protection of the charging order may be pierced by a creditor. In that eventually the charging order limitation becomes a moot point, because the entity is no longer considered to have a separate legal identity from its owners.

In Litchfield Asset Management Corp. v. Howell,[57] after the judgment against her, the debtor set up two LLCs and contributed cash to the two LLCs. The LLCs never operated

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under consideration is clear on its face, a court can not go beyond the statute in determining legislative intent.")

[53] *Id*.

[54] See, *e.g.*, Sutherland, *Statutory Interpretation*, Section 22.33 (C. Sands 4th ed. 1972); Walen v. Department of Corrections, 443 Mich. 240, 248, 505 N.W.2d 519, 522 (1993); McLeod v. Santa Fe Trail Transp. Co., 205 Ark. 225, 230, 168 S.W.2d 413, 416 (1943); Woodson v. State, 95 Wash. 2d 257, 623 P.2d 683 (1980).

[55] For a more in-depth discussion of the Albright decision, see Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 Del. J. Corp. L. 199 (2005); Thomas E. Rutledge and Thomas E. Geu, *The Albright Decision – Why an SMLLC is Not an Appropriate Asset Protection Vehicle*, 5 Business Entities 16 (2003).

[56] Albright at 544, fn 9.

[57] 70 Conn. App. 133, 799 A.2d 298 (Conn. 2001). For a similar result, see C.F. Trust, Inc. v. First Flight Limited Partnership, 306 F. 3d 126 (4th Cir. 2002).

a business, never made distributions or paid salaries, and the debtor used the assets of the LLC to pay her personal expenses and to make interest-free loans to family members.[58] The court found that the debtor used her control over the LLCs to perpetrate a wrong, disregarded corporate formalities and exceeded her management authority (in making interest-free loans), and ordered reverse piercing of the LLCs.

Because there has always been a strong presumption against piercing the corporate veil (including reverse piercing), this threat to the charging order protection should be easily avoidable.[59]

Practitioners using partnerships and LLCs to protect personal property, such as investment accounts and residencies should be wary. While most states allow the formation of partnerships and LLCs for any lawful purpose,[60] other states require a business purpose (profit or non-profit).[61] In a state requiring a business purpose, a partnership or an LLC holding personal property may be subject to a reverse piercing claim. Entities holding personal assets should be formed in states like Delaware, that allow entities to be formed for any lawful purpose.

g. Tax Consequences

The tax consequences of the charging order, to the creditor and to the debtor, vary before and after foreclosure.

Until the charging order is foreclosed upon, it is a lien on the debtor's transferable interest and can be compared to a garnishment. If the entity makes distributions to the creditor, then the tax consequences to the creditor are determined with reference to the underlying judgment.

The distributions made pursuant to a charging order are made in satisfaction of a judgment. Judgments are taxable based on the underlying cause of action, according to the "origin of the claim" test.[62] For example, if the judgment relates to a personal injury or sickness, it may be entirely exempt from income under Code Section 104(a). If the judgment does not relate to a personal injury or sickness, it will be taxable as either ordinary income or capital gain. Generally, recovery which compensates for harm to capital assets is a capital gain.[63] All other income is ordinary.[64]

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[58] For a contrary holding, see 718 Arch St. Assoc. v. Blatstein, 192 F.3d 88 (3rd Cir. 1999), where the corporation paid personal expenses of the shareholder, but the shareholder included these payments as income on his tax return.
[59] Blatstein at 114.
[60] See, *e.g.*, Colorado Revised Statutes Section 7-80-103, Delaware Code Title 6, Section 18-106, Ohio Revised Code Section 1705.02.
[61] See, *e.g.*, California Corporations Code Section 17002(a).
[62] U.S. v. Gilmore, 372 U.S. 39 (1963).
[63] Rev. Rul. 74-251, 1974-1 C.B. 234.
[64] Code Section 61(a).

While the creditor is being taxed on the distributions it receives, the debtor is also being taxed on the income of the entity. There are three ways to arrive at this conclusion. First, absent foreclosure, the debtor remains the owner of the economic interest in the entity. And whether the entity is taxed as a sole proprietorship, a partnership or a corporation, it is the owner of the economic interest who is properly taxable.[65] Second, paying off the creditor reduces the outstanding liabilities of the debtor, which is an economic benefit to the creditor, and therefore taxable under the Haig-Simons definition of income.[66] Third, the charging order simply forces the debtor (to the extent it works) to pay off its debts. Paying off debts is not always deductible (see following paragraph), and changing the mechanism of debt payment (debtor paying creditor directly after getting taxed on its share of distributions, versus intercepting distributions from the entity) should not alter that result by giving the debtor an equivalent of a deduction.

The debtor may be able to obtain a deduction for any distributions made by the entity to the creditor, if the judgment relates to the debtor's business, and paying it off would be deemed an "ordinary and necessary" business expense.[67]

If there are no distributions being made to a creditor, then (absent foreclosure) the creditor is not taxable on the income of the entity.

Once a creditor forecloses on the partnership or membership interest, the charging order lien is converted into an actual economic interest in the entity, now owned by the creditor (or the buyer of the interest at a foreclosure sale). For federal tax purposes, the creditor acquires a property right in the economic interest (compared to the right to income), and is now treated as the owner of such interest.[68]

The tax consequences to the creditor depend, on two factors, (i) whether distributions are being made, and (ii) the federal income tax treatment of the entity.

If distributions are being made, then if the entity is taxed as a sole proprietorship (because it is disregarded for tax purposes)[69] as a partnership, or a subchapter S corporation, both the debtor's share of the income of the entity and the character of the income being generated by the entity will pass through to the creditor. If the entity is a subchapter C corporation, its distributions will be taxed to the debtor as dividends.

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[65] Blair v. Comr., 300 U.S. 5 (1937) (gross income from property must be included in the gross income of the person who beneficially owns the property). Evans v. Comr., 447 F. 2d 547 (7^{th} Cir. 1971) (the "real ownership" of the partnership interest was vested in the person who exercised dominion and control).
[66] Rutkin v. U.S., 343 U.S. 130, 137 (1952).
[67] Code Secton 162(a).
[68] Evans v. Comr; Rev. Rul. 77-137, 1977-1 C.B. 178. This Revenue Ruling ruled that an assignee that acquired "dominion and control" over the economic interest was to be taxed as a partner of the partnership.
[69] An entity may be disregarded for tax purposes if it is (i) a single-member LLC, (ii) either a limited partnership or an LLC owned by one person for tax purposes, or (iii) an LLC where only one member holds an economic interest and the rest possess only management rights. An example of a clause (ii) fact pattern is a limited partnership where individual A is the sole limited partner, and an LLC owned entirely by individual A and treated as a disregarded entity is the sole general partner.

If distributions are not being made to the creditor, then if the entity is taxed as a sole proprietorship, partnership or subchapter S corporation, the creditor is still taxed on its share of the income of the entity, causing the creditor to generate phantom income.[70] The creditor will not be taxed on the income of the entity until it is distributed, if the entity is a subchapter C corporation.

h. Bankruptcy

When a partner or a member files for bankruptcy protection, the debtor's interest in the entity is transferred to his bankruptcy estate. The relevant question is whether the interest now owned by the bankruptcy estate includes the debtor's management rights, or solely his economic rights. Pursuant to the uniform acts and state statutes, the bankruptcy trustee should acquire the right to receive the debtor's share of distributions, but not his control over the entity. Bankruptcy laws may provide for a different answer.

Section 541(a) of the Bankruptcy Code provides that the bankruptcy estate will include all legal or equitable interests of the debtor in property. The courts are generally in agreement that Section 541(a) would apply to both economic rights and management rights of partners or members.[71] Section 541(c) provides further that no restriction on the transfer of any interest of a debtor (whether the restriction appears in a contract or under state law) prevents the interest from becoming property of the estate.[72]

Section 365(c) of the Bankruptcy Code provides, in turn, that if an executory contract contains transfer restrictions that are valid under state law, the trustee may not assume or assign such a contract. Consequently, if a partnership agreement or an operating agreement constitutes an executory contract, then the restrictions on transferability of interests in such agreements would preclude the trustee from obtaining rights other than economic rights.

In determining whether a partnership or operating agreement is an executory contract, the court in Garrison-Ashburn concluded that the operating agreement was not an executory contract because it only established the management structure of the LLC, but did not create any duties of members to each other or to the LLC.[73] The court noted that in the operating agreement there "is no obligation to provide additional capital; no obligation to participate in management; and no obligation to provide any personal expertise or service to the company."[74]

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[70] Pursuant to Code Section 61(a) if a sole proprietorship, Code Section 704(b) if a partnership, and Code Section 1366(a) if a subchapter S corporation.
[71] In re Garrison-Ashburn, L.C., 253 B.R. 700, 708 (Bankr. E.D. Va., 2000).
[72] Garrison-Ashburn at 708 ("Section 541(c) [of the Bankruptcy Code] makes plain that no restriction on the transfer of any interest of a debtor -- whether it arises from the operative documents themselves or from applicable nonbankruptcy law -- prevents an interest from becoming property of the estate").
[73] *Id.*
[74] *Id*. at 708-709. A similar conclusion was reached in In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005). For a contrary holding, see, Broyhill v. De Luca, 194 B.R. 65 (Bankr. E.D. Va., 1996) (operating agreement called on the members to provide continuing personal services).

It appears that in the context of bankruptcy, there is no clear cut answer whether the trustee (standing in the shoes of the creditors), will acquire solely the economic rights of the debtor, or the voting rights as well. If bankruptcy is contemplated, then the partnership agreement or the operating agreement should be drafted to impose various obligations on members – obligations to the entity and to each other. However, even if the contract is deemed to be executory, it is always possible to come across an "Albright" type court that will not even consider the executory nature of the contract.[75]

i. Maximizing the Utility of Charging Orders

Most partnership and operating agreements being drafted today provide that only the economic interest in the LLC may be assigned, but not the entire membership interest. This mirrors the uniform acts and the various state statutes.

A carefully drafted partnership or operating agreement can greatly enhance the charging order protection. As discussed above, the statutes allow partners and members to override the default statutory provision of assignability of interests. In most business dealings it would not be possible for practitioners to make LLC interests entirely non-assignable. Clients want to retain flexibility and ability to dispose of their LLC interests. However, in family settings, or for LLCs set up solely for liability protection purposes, it may be possible to either prevent assignability altogether or to limit it in such a manner so as to make the charging order remedy of little value to the creditor.

Because the charging order protection is predicated on the debtor's continued ability to manage the entity and thus control distributions, the distribution clauses of partnership/LLC agreements become critical. If the agreement provides that all distributions must be made to the partners/members on a pro-rata basis, then distributions have to be made either to all partners/members or none. This means that if one partner/member is pursued by a creditor holding a charging order, protecting that partner/member would mean withholding distributions from all other partners/members of that LLC. Consequently, agreements should be drafted to deal with this potential problem.

One possible solution is to allow the general partner or the manager, in the partnership or operating agreement, to make distributions to all other members, and not the debtor-member. The author's preferred solution, is to provide that the debtor vests in the distribution (*i.e.*, cash and assets are distributable to the debtor) but instructing the general partner or the manager to withhold the distribution while the charging order is pending. This allows the entity to allocate taxable income to the creditor (following a foreclosure) without distributing cash to the creditor.

Pursuant to the uniform acts and most state statutes that allow foreclosure, prior to the foreclosure, the debtor may redeem its partnership/membership interest.[76] The statute

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[75] For a more in-depth discussion of charging orders in the context of bankruptcy, see Thomas E. Geu and Thomas E. Rutledge, *Guess Who's Coming to Dinner?*, 7 No. 2 Business Entities 32 (2005).
[76] RUPA Section 504(c), ULLCA Section 504(c), ULPA Section 703(c).

does not specify that the interest must be redeemed for fair market value. This leaves room for drafters to insert various favorable redemption provisions into the operating agreement, such as a poison pill.

A poison pill provision usually allows either the entity itself or the non-debtor partners/members to buy-out the debtor for a nominal amount of money. The poison pill has the effect of substituting the debtor's interest in the entity with a nominal amount of cash, which limits the assets that a creditor can collect against. If the entity is established well in advance of any creditor challenges, when the partners/members do not know who will benefit from the poison pill and who will find it detrimental, it should be enforceable (although there are no cases on this point). Because the poison pill will kick in automatically, it should not be deemed a fraudulent transfer, although a challenge is likely. Poison pill provisions are usually limited to family-setting LLCs where the family members are on good terms with each other.

j. A Practical Take on Charging Orders

Charging orders generally allow debtors to retain control over partnerships and LLCs and determine the timing of any distributions. There are some exceptions to that general rule, particularly when the following facts are present: (i) there is a fraudulent transfer, and (ii) in the context of bankruptcy. It may be argued that single-member LLCs should also be deemed an exception to this general rule, based on the Albright case and the historical origin of charging orders. This author believes the Albright case to be an outlier, and in direct conflict with the charging order statutes of all states that have adopted single-member LLC provisions. Historical origin is also of little significance in this area. There is no need to interpret statutes that are very clearly drafted to apply to all LLCs.

Purchasing a foreclosed partnership interest may be foolhardy when the debtor, or a person friendly to the debtor, remains in control of the entity and can hold up the creditor's share of distributions. This will lead to adverse tax consequences for the creditor.

As a practical matter, creditors rarely chose to pursue charging orders.[77] A charging order is not a very effective debt collection tool. The creditor may find itself holding a charging order, without any ability to determine when the judgment will be paid off. Practitioners should remember that any uncertainty surrounding charging orders is uncertainty for both the debtor and the creditor. This uncertainty forces most creditors to settle the judgment with the debtor, on terms more acceptable to the debtor, rather than pursue the charging order remedy.

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[77] This conclusion is based on anecdotal evidence and the author's own experience. There are no available statistics.